DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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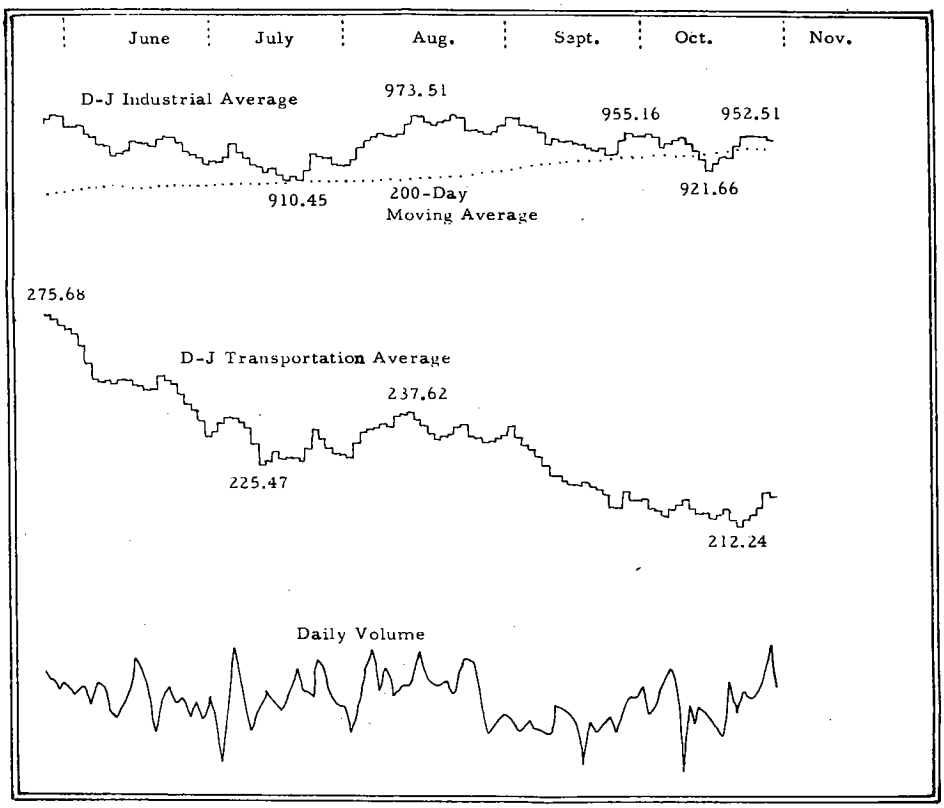
Oct. 20, Dow 942.81, PTI 912, A-D ratio -4.40
Oct. 27, Dow 946.42, PTI 923, A-D ratio -3.79

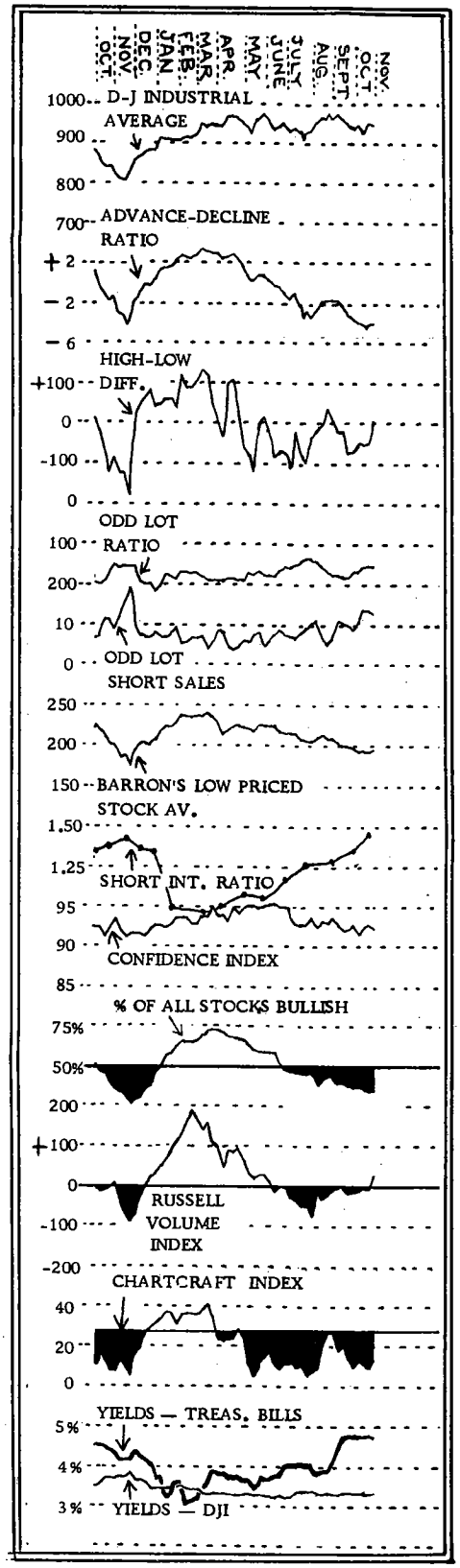
THE PICTURE: I hesitate to write this because it may sound "inhumane," but after years in office, after years in which they could have been doing exactly what they are doing now, the sight of the Administration suddenly scrambling around the Washington-Paris-Asia route in a frantic effort to bring off a peace or at least a cease-fire is not without its nauseating aspect. Having myself dropped bombs during World War II, I am not totally ignorant of the effects of high explosives on human life, and veteran subscribers know that for years I have taken a dim view of the Vietnam War, our part in that war, our motives, our progress and our chances of "success." My sentiments have not changed over the years.

Yet somehow, the supposed final negotiations (which have exploded just weeks before the election) have left me with a feeling of numbness (and I gather I am not alone in this). So after all the lies, all the agony, all the promises, after four million dead and wounded on both sides, has it come down to something which could have been duplicated one, three or even five years ago? All in all, I would term the Vietnam affair one of the grisliest and most depressing chapters in the history of the human race.

What is George McGovern's place to be in the sweep of history? Will he go down merely as the spark that lit a fire under Mr. Nixon? Will he, in the great scheme of things, be the Presidential contender who forced the insanity of this hideous undeclared "war" out into the open? Or will he be the man who questioned the mindless thesis of "my country, right or wrong"? Let history be the judge.

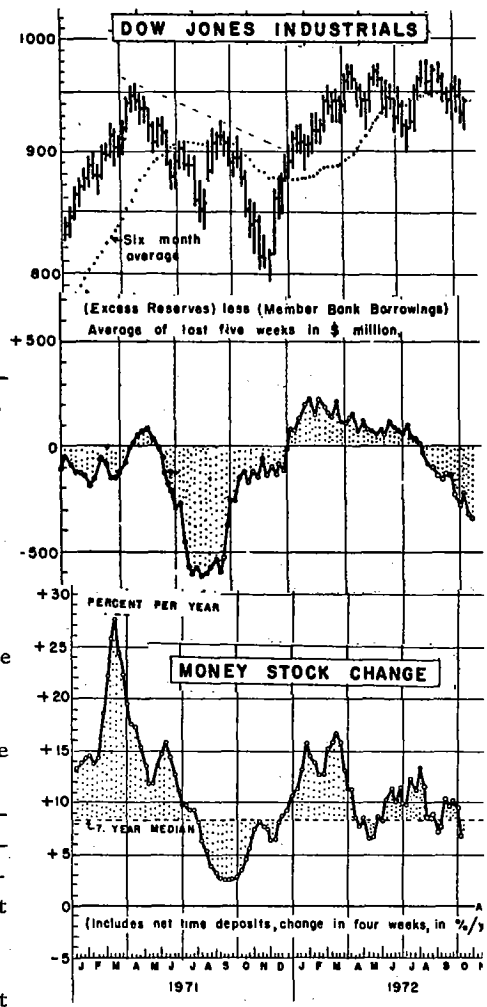
Meanwhile, buried in the newspapers last week was news of the latest meeting of the European Common Market. At Paris the members pledged to pool their resources in competition with the US business machine. They also set up a $1.4 billion cooperative

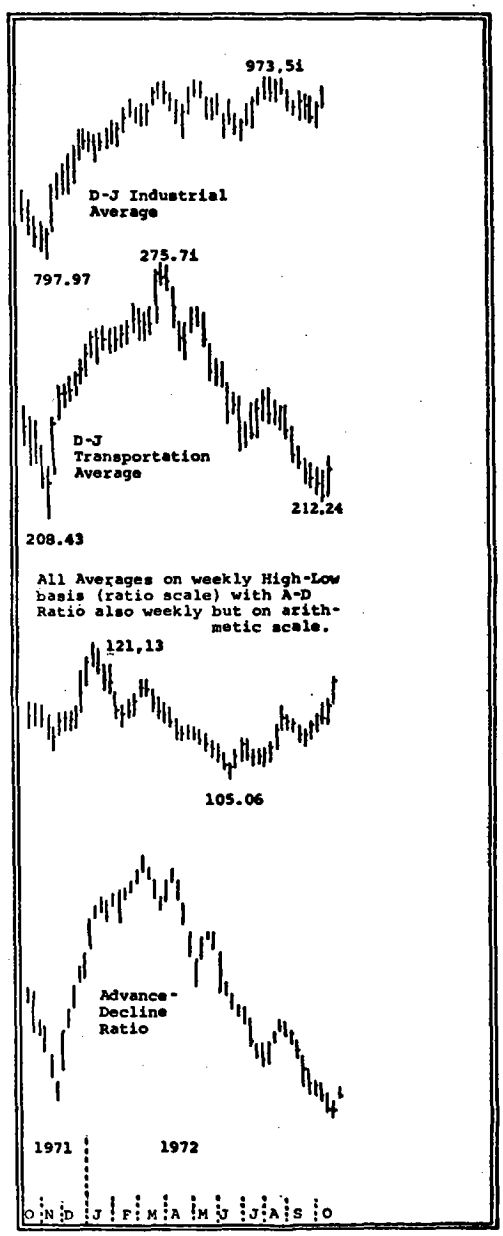




fund to ease currency settlements among the Community. There was serious talk of a single European money system, a unified economic system, a joint fight against inflation, Mr. Pompidou of France listed a few goals which the US does not share — a higher price for gold and dollar convertibility.

Perhaps most important was the overriding theme that the Common Market would embark on policies and plans independent of and in competiton with the US. Thus an ultimate united states of Europe will arise, and its combined power, resources and productive ability is to be a factor which will, in time, reshape the economic power structure of the world.





Undoubtedly, the stock market is the "mystery" area of the current US scene. Why isn't Wall Street reflecting the bubbling economy, the consumer spending, the optimistic forecasts issued by our leaders in and out of Washington? As I've said before, sometimes what the stock market "is not doing" is the most significant thing around. And one thing the stock market definitely has not been doing is booming in reflection of the promised economic expansion of 1973 and even 1974.

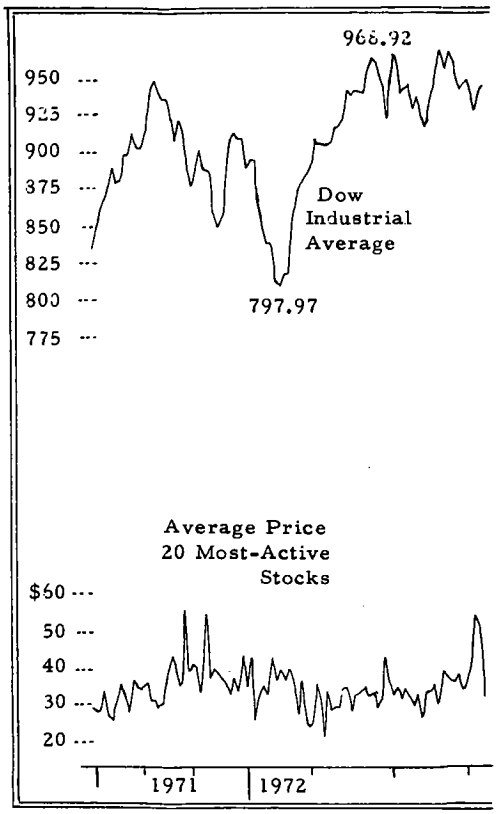
Every conceivable stimulation and argument has been brought out to boost, cajole or pressure the stock market to higher levels. We are told that price-earnings for most stocks and the Dow are low, the market is over-sold, the public did not come in during 1972, many stocks are now at bargain levels. In fact, I do not ever remember such a concerted and single-minded effort to convince the public and Wall Street that all is well and getting better.

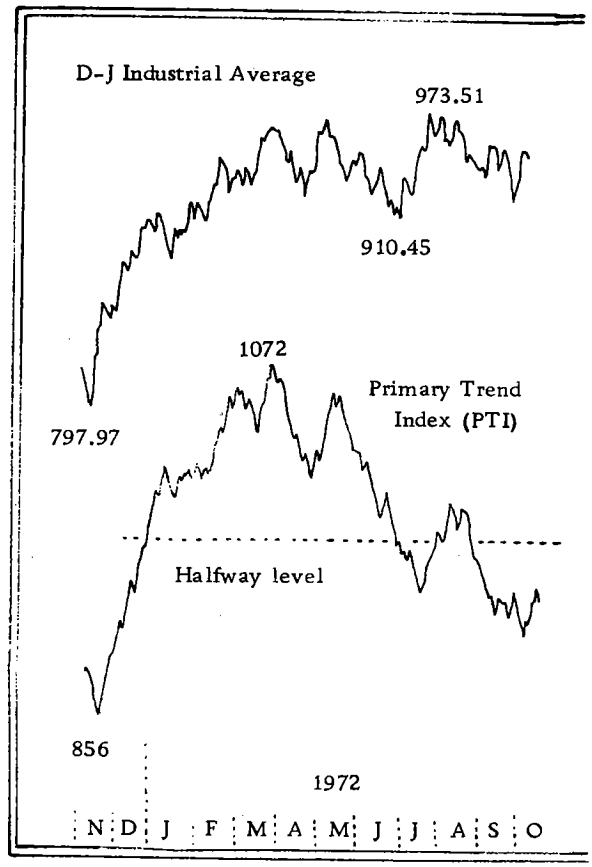
Meanwhile, the Federal Reserve Board seems to be having second thoughts on the current inflationary whirlwind which is blowing across the US. Since economic changes do not usually take place for months following an expansion or contraction of credit, I have been noting with interest the trend of free reserves as well as the money stock change. These charts along with the D-J Industrials are most interesting to me, and it can be seen that the trend of these monetary indices often precede the trend of stocks on Wall Street. If so, the post-election period will be less "rally-prone" than many believe (charts courtesy of Merrill Analysis, Box 228, Chappaqua, NY 10514).

A friend called from New York yesterday and said, "I've figured what this market is all about. It's the stock market's 'revenge' on the investment world. It's becoming increasingly obvious to me that the market is intent on driving the public out of Wall Street, the fund managers out of their jobs, the brokers out of business and the analysts out of their minds." A secret thought has been haunting me ever since our conversation, and that thought is, "Could my friend be right?"

At any rate, I include the weekly chart on this page showing four of the indices which we watch most closely. Here we see the Industrials still confined to their 8% range of 1972, the tightest annual range in modern history. The Transports, having declined within 5 points of their 1971 bottom, have now decided to "bounce" higher. Utilities, now providing the most favorable dividend yields in years, have been moving higher since June, 1972. And the advance-decline ratio, reflecting the advancing or declining tendencies of all NYSE issues, established a 1971-72 low only a few weeks ago on October 16.

The chart at far right shows the relationship (daily) of the Dow and the Primary Trend Index (PTI), an index composed of eight critical market indicators dealing with both price and technical character (four stock averages, a bond average, the A-D ratio, high-lows, most-active stocks). The PTI is currently holding below the halfway mark of its 1971-72 rise (halfway level is designated on the chart by the dashed line). Thus, this most sensitive technical indicator has not completely broken down (i.e., has not broken its 1971 low) nor has it confirmed the strength of the Dow. In this respect, it is proving to be an "honest" indicator, simply by saying that the "story has not yet been told."



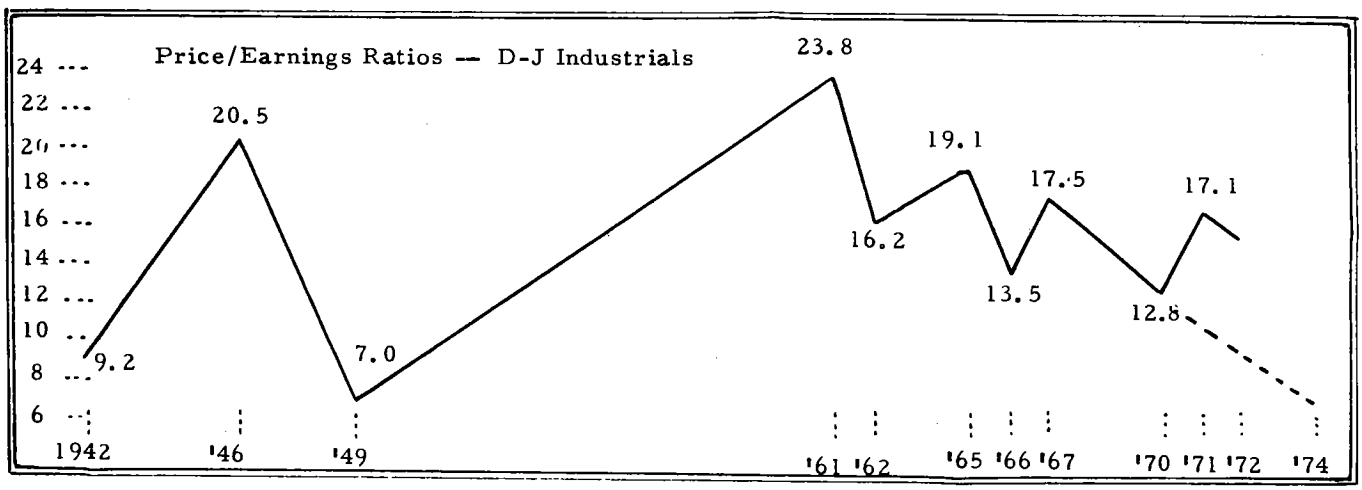


An interesting sidelight to this market is portrayed by the chart above at left showing the weekly average price of the 20 most-active stocks. This index has jumped into the mid-50's, highest level in a year. A high level on this indicator usually reflects a turn to safety and conservatism by Wall Street's "activity element." Such moves towards safety have, in the past, often preceded or coincided with declines, as was the case in 1971.

PRICE-EARNINGS RATIOS: Last week I went back and re-studied the price-earnings ratios on the Dow. This is always a fascinating and often surprising study. To aid me in seeing the picture, I drew a long-term chart of the Dow P/E ratios starting with the 9.2 of 1942.

The year 1942 marked the beginning of the 1942-46 bull market. Investor sentiment was gloomy in 1942, the war was going badly for the Allies, and that year saw investors willing to pay as little as 9.2 times earnings for the 30 Dow Industrials.

But as World War II neared an end, as the giant stored-up needs of the country became obvious, investors turned more hopeful regarding the value of earnings on the Dow. By 1946 Wall Street was ready to be optimistic, and they were paying 20.5 times the Dow's earnings. That relatively high P/E ratio marked the top of the 1942-46 bull market. I remember this period well. Following the 1946 "crash," the market headed sharply lower, and the talk was that the "Post-War Depression" was on its way.



Despite the fact that a depression did not appear, the pessimism on Wall Street was widespread. Nothing could shake investors from the view that prosperity was over. When a fairly severe recession did hit during 1949, the general feeling was "Ah, the worst is arriving just as we thought it would." The year 1949 (see chart) saw the Dow sell at an extraordinary 7 times earnings. This represented the greatest bargain climate of the whole post-World War II era.

Despite recessions, the Korean War, the Suez incident, the Sputnik Panic and a dozen other depressants, price earnings ratios climbed steadily higher. By 1961 P/E ratios on the Dow touched a peak of 23.8. This was, no doubt, partly brought on by the almost universal acceptance of the "Soaring Sixties", and the wildly optimistic pictures painted by economists and businessmen of the brave new world which lay just ahead. Amid this euphoria, the P/E ratio on the Dow turned down. It was as if the Soaring Sixties talk had reflected the very peak of optimism, at least as to how much investors were willing to pay for earnings on the Dow.

I have drawn the period following 1961 on the chart in a little more detail, since I wanted to show the definite series of declining peaks and bottoms in the Dow P/E ratio. In 1964 the peak P/E ratio for the Dow was 19.1, the 1967 peak was 17.5 and the latest or 1971 peak was 17.1. Note also the declining bottoms for Dow P/E ratios, the 16.2 of 1962, 13.5 of 1966 and the 12.8 of 1970. Will the progression continue? Obviously no one can know for sure.

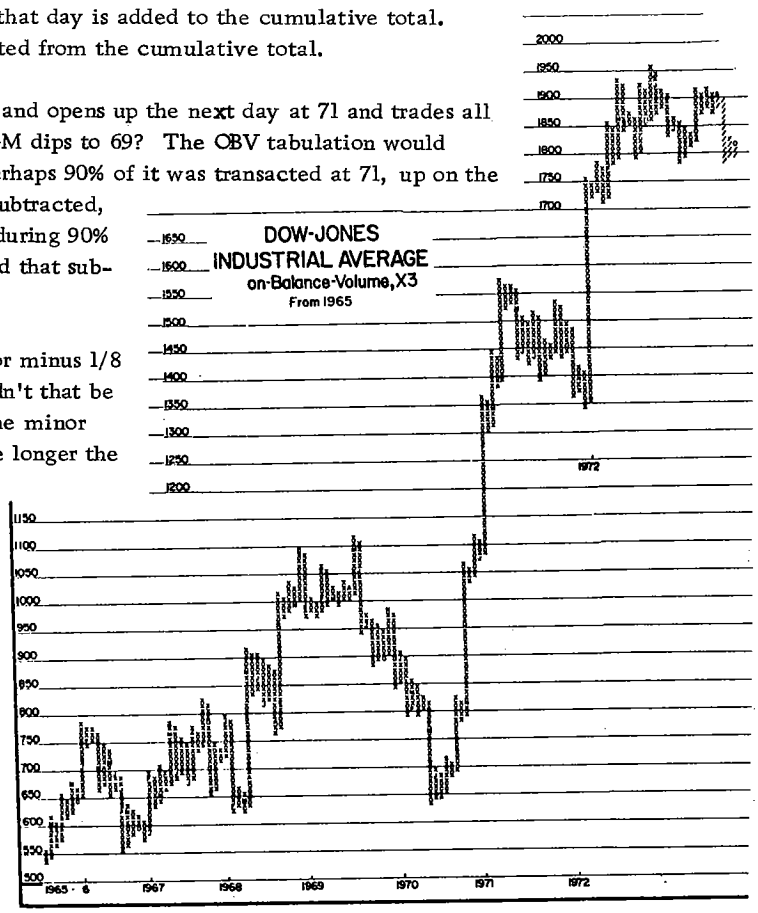
But here is a guess regarding how this bear market could end. The rise from the 1949 low of 7 on the Dow P/E to the 1961 high of 23.8 took roughly 12 years. If it took roughly another 12 years or so to run the full cycle down, we might expect a low on Dow P/E ratios some time during 1973 or 1974. It might even take another year, since the Government is mounting the greatest campaign to produce optimism that I have ever seen.

At any rate, assuming that the bear market produces its lowest P/E ratios during the 1974-75 period, it would not surprise me to see those ratios drop back to the 7 to 10 area (or around those which existed during 1942 and 1949). If the US economy was to slump during this period of final decline in P/E ratios, we could see extraordinarily low prices on the Dow. For instance, I could envision the Dow selling for 8 times $50 earnings, producing a Dow level of 400. At any rate, this study should help readers understand the P/E ratio cycle and the crucial meaning of investor psychology in the market. For the P/E ratio is often the leveraged factor in the price of the Dow. And as of now, despite a veritable flood of Government propaganda and manipulation (which actually went into high gear during the Johnson Administration), the trend of P/E ratios on the Dow continues down. This is the fact that is undoubtedly driving Washington "up the wall."

ON-BALANCE-VOLUME IN THE DOW: In the last Letter I explained the concept of on-balance-volume, the outstanding technical tool developed by Joseph Granville. OBV tabulations are arrived at as follows: A cumulative total of volume is kept. On a day when price rises, the volume for that day is added to the cumulative total. On a day when price declines, volume for the day is subtracted from the cumulative total.

But, objects the readers, suppose GM closes at a price of 70 and opens up the next day at 71 and trades all day at 71? But then during the last five minutes of trading GM dips to 69? The OBV tabulation would subtract all the volume for that day, despite the fact that perhaps 90% of it was transacted at 71, up on the previous day. And I would say, yes, the volume would be subtracted, and if GM closed at 69 (regardless of where the trading was during 90% of the day) I would say that we saw a weak performance, and that subtracting total volume for the day would be correct.

How about if a stock goes by on big volume all day at plus or minus 1/8 and closes say down 1/8? That is a big drop in OBV. Wouldn't that be deceptive? Perhaps, but over a reasonable period of time the minor discrepancies tend to cancel themselves out. Moreover, the longer the period, the more correct an OBV chart is liable to be (in regards to showing the true direction of buying or selling volume).



At any rate, I want to turn to a striking OBV chart of volume in the Dow Industrials (courtesy of "The Crosschart Book," 18 E. 41st St., NYC 10017). This is a point & figure chart showing all movements in OBV on the Dow since 1965. One factor of immediate interest is that in studying the 1969-70 period, we notice that there was no great or sever plunge in Dow OBV. How could this be? The answer is that during the great 1969-70 decline, there were a good many days in which volume expanded on the rallies and contracted on the declines. From this standpoint, it it clear that despite the shocking losses of 1969-70,

a large amount of "enthusiasm" for the upside persisted, and this can be measured by the fact that the Dow OBV did not register a massive collapse during this period (as it would have if volume came in steadily in the downside, then dried up on the upside).

In contrast, note the huge rise in Dow OBV during the 1970 to 1972 rise. Here we see the results of real enthusiasm for the upside as Dow OBV traced a giant "stilt" formation, far outdistancing the OBV downside profile of 1969-70.

What is the meaning of all this? In my opinion, this picture is going to come into balance, and by that I mean that OBV will ultimately drop as drastically as it climbed during 1970-72. This, of course, will reflect liquidation on expanding volume, something we really have not yet seen in the bear market which started at the 995.15 Dow peak of February, 1966.

Currently, the Dow OBV chart suggests that a huge top is forming, and that the next major move could well be down on expanding volume. If and when this occurs, I will discuss it in these reports. It seems to me that a bearish signal would come on this chart if OBV for the Dow dropped below the 1700 level.

TWO WORLDS: The stock market may be seen on two levels, the "outer" level, which is the world of the obvious, the fundamentals, the news, the tangible. And then there is the "inner" level, the technical, the mysterious sub-surface world which the technician seeks to unfathom. This inner market world is the one that can produce a 1962 crash when all appears well on the outside, when nothing published or within sight of the trained economist gives a hint as to the chaos within.

By the same token, the human world can be experienced on two levels, the outer world of the conscious, the world we deal with, the world we talk "about." And then there is the inner world of the unconscious, the psyche. The great Gestalt Psychiatrist Dr. Frederick Perls likened these two levels to the "top dog" and the "bottom dog," and he noted that there was always a certain distance separating these two "clowns" (as he termed them).

Few people are aware of the tensions and turmoils which rage within themselves as the conscious and unconscious battle for control of the "self." The top dog (conscious) is the one which says, "You should do this," "I must get that done." Top dog is often self-righteous, pushy, a tyrant. And sly bottom dog (the unconscious) replies, "Oh, I don't really have to do that," or "I'll do it, ok, ok, but let's wait till tomorrow." Bottom dog is so artful and sneaky that he more often than not wins the battle.

Where top dog totally rules the person we get the stern disciplinarian, the arch conservative, or the ultra-moralist. Where the bottom dog totally rules we can get the criminal, the great artist, the mad writer. Where the two dogs are too far apart (when they will have nothing to do with each other) we get the schizophrenic, the split personality (and I know a bit about this since I have a daughter who is schizophrenic). Where the two "dogs" (conscious and unconscious) are close together or "fully integrated," in these very rare instances, we get the genius. Even in folk language the highly effective man is the one who "has it all together."

I believe that the wave of the future will be the gradual realization among medical, religious, ethical and social leaders that the great battle is in each individual's search for the inner man, the struggle for the integration of the personality. This may come about in any number of ways, but in my opinion it will come through the realization that the vast majority of diseases are basically physical reflections of the turmoil between the conscious and the unconscious.

Personally, I have spent my life in the struggle to uncover and then integrate my own two sides, and I can state that it is by far the most difficult struggle I have ever seen or heard of (without my wife's persistent help and sheer genius, I would have gotten nowhere). Unfortunately, I know of no single book or brand of therapy which will automatically open the door to the inner mind. Some do it with religion, some with meditation, some with psychiatry or encounter groups, but most do not attempt it at all. For those readers who are interested in this fantastic and rewarding field, I would like to recommend a book by Dr. Frederick Perls entitled "Gestalt Therapy Verbatim" (paperback). To my mind, the first section of this book (which is simply called "Talk") represents one of the great documents of human thought (I have read this section perhaps 50 times and am still learning from it).

If the above helps 1% of my readers, itwill have been worth it to me. I hope the other 99% will indulge me.

STOCKS: Continuing the discussion of the technical aspect of the Dow stocks, I include new charts of additional Dow Industrials on page 6. Owens Illinois I have graded with a low 1 (out of a possible 5, see last Letter) as OI has only a mildly rising trend in its odd-lot ratio to recommend it from the technical standpoint. The stock has been making the new low list and is holding well below its 10-week moving average. On-balance-volume (OBV) is sagging and relative strength (RS) on this stock is poor. Actually, OI is only about 10% above its 1970 bear market low, and it will be interesting to see whether the technical situation in OI remains weak.

General Electric is also graded with a low 1, and here again only the odd-lot ratio is a plus in the technical picture. Obviously, as the stock sells off the odd-lotters have been moving more strongly towards the sell side as seen by the odd-lot indicator at the bottom of the chart. OBV on GE is poor and RS has been moving generally sideways to lower. GE is one of the Dow stocks which does possess a short interest, although the short interest in GE has been trending slightly lower over the past few months. I would say that GE is headed down or that it will be a laggard on any rally.

The third stock for discussion here is a puzzler, Swift. OBV on Swift is good, as we can see by the well-defined upward zig-zag to new highs. RS, on the other hand, has been poor and has recently dropped to new lows. But the biggest mystery is the huge amount of odd-lot selling which has recently taken Swift's odd-lot ratio as high as 3400 (3400 shares sold for every 100 purchased by odd-lotters!). This made Swift one of the heaviest sold stocks (on the part of odd-lotters) on the Board.

Such intense selling by the public should ordinarily constitute a strong technical plus. Swift has moved back and forth in the 30 to 38 area for almost a year now, and the refusal of SWX to break out on the upside may be a great discouraging factor for odd-lotters. On the basis of OBV and the odd-lot situation in SWX, I would say that it is one of the better technical situations in the Dow thirty industrials, even though it has not really gone anywhere in the past year. If I were to speculate in Swift, I would nevertheless wait until it had moved to 35 or above its 10-week moving average.

As of the latest reading, conservative Amer. Telephone has a bullish 5 reading and Proctor and Gamble has a 3 along with Standard of California, Jersey and Texaco. These are the four strongest stocks in the Dow. Zero readings belong to Alcoa, Allied Chemical, General Foods, Goodyear, Int. Nickel, Johns Manville, Owens Illinois.

Interestingly, eight Dow Industrials have good technical readings of 3 to 5, while 18 have poor readings of zero or 1. This may tell us something about the path of the Dow Industrials over the near-term.

GOLD: As seen on the chart, the bullion price of gold is holding well above $64. The anti-gold propaganda has once again driven the stocks down. Patience, patience, the patience of 10 men...